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TAGS: EAGR ECON EFIN EIND EINV IN
SUBJECT: MUMBAI ECON MASALA: ECONOMISTS EXPRESS CONCERN OVER FISCAL
DEFICIT, DROUGHT, AND INFLATION; INTEREST RATE FUTURES LAUNCHED

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¶1. Mumbai Econ Masala Contents:

n Economists Point to Rising Production and Capex as Positive
Economic Indicators~.

n ~But Note Concerns of Rising Inflation and Fiscal Deficit

n Deficit Continues to Concern Economists

n Interest-Rate Futures Reintroduced in India

Economists Point to Rising Production and Capex as Positive
Economic Indicators~.

¶2. Mumbai-based economists have maintained their GDP estimates for FY2009-10 in the 5.8-7.0 percent range despite drought conditions in parts of the country which are likely to affect agricultural growth. Some believe that a sharp rise in factory output, among other factors, could help mitigate the effects of a poor monsoon. The industrial production growth, led by a recovery in manufacturing sector, accelerated to 7.8 percent in June from 2.7 percent in May. (Note: Manufacturing sector contributes to two-thirds of the industrial production numbers. End Note.) The purchasing managers' index, or PMI (another measure for manufacturing output), remained over 50 for the fifth consecutive month, indicating a rise in factory production, although it dipped to 53.2 in August from 55.4 in July. However, Sonal Varma, the India Economist at Nomura Advisory Services, warned that quick growth in manufacturing activity as indicated by the production data might not be sustainable. She explained that the first quarter mainly saw destocking activities, as firms tried to sell existing stocks. However, now firms are building up new stocks, anticipating a

rise in demand spurred by government spending, resulting in a rise in production numbers.

¶3. Varma indicated that overall, Indian businesses are now finding the environment for financing more benign although banks have not yet returned to pre-crisis lending levels. Currently, banks in India are storing Rs. 1.2 trillion (USD 24.62 billion) with the RBI on a daily basis, as compared to a daily average of just Rs.300 billion (USD 6 billion) prior to September 2008. She acknowledged that lower credit demand, which had not returned to pre-crisis levels, also contributed to the rise in bank deposits with RBI. Though businesses were not announcing large expansion plans, she admitted, that there was a pickup in capital expenditure (capex). A firm's investment decision is dependent on its ability to raise funds and future demand prospects, both of which have eased, she said. Vyas, in agreement, added that huge capacities had been built-up in cement, power and steel sectors. These companies had funded their capex plans mainly from internal accruals. According to an analysis carried out by Mint, a leading business newspaper, there was a clear rise in capex as compared to the previous slowdown in 2002-03. Net fixed assets grew by 15.5 percent in 2008-09, slower than the growth of 20.4 percent in the previous year, but still rather high. RBI data also indicate that capex sanctioned by banks and term lending institutions has grown by 25 percent in 2008-09. Varma added that the busy credit season starting in October will be a better indicator of general market trends.

~But Note Concerns of Rising Inflation and Fiscal Deficit

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¶4. The consumer price index (CPI), the Indian inflation rate based on retail prices for industrial workers, rose 11.98 percent in July 2009 from 9.28 percent in June, mainly due to rising food prices. Recognizing this, the Reserve Bank of India (RBI) in its July monetary policy review raised its inflation forecast for this fiscal year 2009-2010 to five percent from four percent, although India's benchmark inflation rate -- the Wholesale Price Index (WPI) has become negative due to the base effect of last year's high energy prices. Varma believes that the RBI sounded "hawkish" on inflation and would take steps to remove liquidity from the banking system. (Note: The RBI has infused liquidity of about USD 115 billion since September 2008. End Note.) She believes that the RBI would increase the cash reserve ratio (CRR) -- the amount of deposits the RBI requires banks to keep with the central bank -- and other policy rates by January 2010. She pointed out that a 1 percent CRR increase had the potential to absorb about USD 5.7 billion from the economy. However, Mahesh Vyas, Managing Director and CEO of the Centre for Monitoring the Indian Economy which is an economic research organization, warned that a premature exit of monetary measures could jeopardize both the nascent recovery and the government's huge borrowing plan. He explained that the rise in prices was due to supply side pressures and therefore should not warrant an interest rate hike.

Deficit Continues to Concern Economists

¶5. In conversations with Congenoffs, Mumbai-based economists are expressed concern about the growing fiscal deficit and are keen to know the government's plan to "unwind" its borrowing programs. The government plans to borrow a record Rs. 4.51 trillion (USD 92.53 billion) to meet its fiscal deficit of 6.8 percent of GDP. Until now, the RBI has sold Rs. 2.61 trillion (USD 53.55 billion) worth of bonds. The increase of government paper has led to a problem of supply management in the bond market. The yield in the benchmark 10-year government securities soared from five percent in April 2009 to 7.35 percent in August 2009. Varma added that banks had requested the RBI to allow the bonds purchased to be classified under the held-to-maturity category so that they do not have to provide for the losses on a mark-to-market basis. Moreover, banks fear that drought-related measures will put additional pressures on the fiscal account, with states like Bihar demanding relief amounting to 0.5 percent of GDP.

Interest-Rate Futures Reintroduced in India

¶6. On 31 August, India expanded the range of risk management financial instruments by reintroducing the trading of interest-rate futures (IRF) to enable companies and investors to hedge against interest rate fluctuations. An IRF contract is a financial derivative with an interest-bearing instrument as the underlying asset. It is an agreement to buy or sell the underlying debt instrument at a future date at a price decided in advance.

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¶7. IRFs were first introduced in India in 2003, but were discontinued within months of the launch due to thin to zero trading volumes. Two systemic deficiencies were cited: the pricing system was considered too complex (based on a zero coupon yield curve which is not directly observable and hence considered theoretical), and banks, who hold a large volume of government securities and might have been the biggest traders of IRFs, were only allowed to hedge but not trade in IRFs. Now, after six years, the regulators, the RBI and the Securities Exchange Board of India (SEBI), have redesigned the IRF contracts which are now based on the 10-year government bond, bearing a notional interest rate of 7 percent, with half-yearly compounding. In addition, the new guidelines allow wider participation, including banks (allowed to trade for themselves and not on behalf of their clients), companies and foreign institutional investors (not for speculation but only to the extent they have an underlying exposure).

¶8. The National Stock Exchange (NSE), India's largest exchange in terms of daily equity turnover, was the first to begin trading. It recorded 1,475 trades resulting in 14,559 contracts valued at Rs. 2.67 billion (USD 55 million), with the heaviest volume in the shortest maturity. (Note: The share of IRFs in the global derivatives market was about 20 percent, totaling to USD 1,400 trillion in 2008. End Note.) The Bombay Stock Exchange, already approved by the regulator for IRF trading, is set to start trading in a few weeks. IRFs are the first major product to be launched by Indian exchanges after the introduction of currency futures in August 2008, which currently

has a daily turnover of more than USD 2 billion.
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